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No. 98-1058

In the
Supreme Court of the United States
October Term, 1998

Robert D. Potts,

Petitioner.

v.

Securities and Exchange Commission,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF OF PETITIONER

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INTRODUCTION

With its decision, the Securities and Exchange Commission (Commission) has effected a sweeping change in the manner by which accounting firms perform audits of publicly held companies. The Commission has dramatically changed the role of the concurring partner, from someone who had a carefully limited role to provide some quality assurance, to someone who must be prepared to reject the assurances of the engagement partner and go behind the evidence assembled by the audit team, *i.e.*, audit the audit. There was nothing in Commission precedent or industry standards that gave the slightest suggestion of this new and expanded role for concurring partners. Because of the profound impact of the Commission's decision on the accounting profession, the American Institute of Certified Public Accountants (AICPA) has filed a brief *amicus curiae* in support of Mr. Potts' petition.

As explained in the initial petition, this case presents pressing constitutional and statutory issues that warrant this Court's review—the due process limits and statutory authority governing the Commission's imposition of livelihood-crippling professional sanctions. The opposition filed by the Commission confirms that the agency is still fundamentally confused about the gravity of imposing professional sanctions and the need for clear standards before imposing such sanctions. Other courts have expressed serious concern about the Commission's confusion and bull-in-a-china-shop approach to professional standards. The Commission weakly states that those decisions are distinguishable, which merely demonstrates that it fails entirely to appreciate the import of judicial decisions stating that it is acting lawlessly in the truest sense of the

word—with little or no regard for the need to adhere to clearly articulated legal standards in an area of profound consequences.

The Commission tries to sidestep the issue through two strategems that merely highlight the need for this Court's review. First, the agency maintains that this case is simply about a fact-specific question of "substantial evidence." The agency thus fails to understand the critically important legal question presented—the nature and content of the legal standards for the Commission's imposition of professional sanctions. Second, the Commission blandly asserts that the professional standard at issue was well-established—an astonishing statement that reveals the agency's insouciance about its devastating professional sanctions. The Commission claims that the professional standard is established by the AICPA's standard, *even though the AICPA itself* vigorously rejects that proposition and even though the agency's punitive sanction flies in the face of the language of the AICPA standard. The Commission claims that its prior decisions set forth what Mr. Potts should have done, merely because those decisions *mention* the term "concurring partner," and fails even to respond to Mr. Potts' explanation that those decisions do not remotely establish the standard said to be violated here.

The Commission's response confirms the importance of this Court's review to clarify the standards governing the Commission's imposition of professional sanctions. This case is a perfect vehicle for addressing this issue, which has generated repeated expressions of judicial concern. The Commission's imposition of professional sanctions is in conflict with the existing professional standard, according to the industry group that promulgated that standard; it is in conflict with the interpretation of Mr. Potts' employer, a

point not disputed by the Commission; it is not supported by prior Commission decisions; and, as the AICPA's *amicus* brief makes clear, the Commission's decision on the merits has profound, real-world consequences for the standards employed by thousands of accountants across the country—a result that is both unwise and beyond the agency's authority.

ARGUMENT

I. Review is Warranted Because the Commission Cannot Articulate a Standard of Conduct That Comports With Due Process.

Before the government can impose punishment it must provide "the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972). The Commission argues that Mr. Potts knew what was expected of him in 1989 and 1990, when he served as concurring partner of the Kahler audits. According to the Commission, it evaluated Mr. Potts' conduct against well-established standards for accountants, as set forth in Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). SEC Brief in Opposition at 11. To flesh out what the AICPA SEC Practice Section guidelines required of Mr. Potts, the Commission claims reliance on the auditing standards of the AICPA, expert testimony and prior Commission precedent. *Id.* On scrutiny, however, these sources fail entirely to support the Commission. Rather, the Commission's reliance on these sources indicates the agency has no idea of the level of clarity needed under its Rule 2(e) to comply with due process.

The guidelines of the AICPA SEC Practice Section are

very general, and the Commission does not dispute that Mr. Potts complied with those guidelines. Likewise, Mr. Potts complied with the more detailed guidelines of his firm.[1] In 1989 and 1990, those guidelines were the sole sources for guidance to Mr. Potts when performing a concurring review. The agency tries to claim that it is "irrelevant" whether the conduct for which it imposed harsh sanctions complied perfectly with the standards of Mr. Potts' employer, one of the leading accounting firms in the nation. *See* SEC Brief in Opposition at 15 n.5. This assertion rings hollow, because at the very least, the policies of Touche, which were consistent with the AICPA's guidelines, must be "relevant" to whether Mr. Potts violated established professional standards.

Recognizing the generality in the AICPA guidelines for concurring partner review, the Commission argues that GAAP and GAAS provided standards of conduct that Mr. Potts could have looked to for guidance. But there is nothing in GAAP or GAAS that even requires a concurring partner review, much less specifically address what an accountant should do when performing such a review. Instead, for concurring partners the Commission imported standards from GAAS that the AICPA intended to apply only to the audit team, which is to be under the exclusive supervision of the engagement partner. The agency's reliance on these auditing standards is dubious and problematic, *see infra* at 9, but even the catch-all duty to exercise due care does not resolve the due process dilemma in which the Commission finds itself.

The obligation to exercise due care is amorphous and

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[1] To be sure, the question whether Touche as a whole properly applied APB-30 is *not* the issue presented, but Mr. Potts wants to point out that he does not agree, as the Commission asserts, that APB-30 was incorrectly applied. He believes, as he has throughout, that Kahler correctly accounted for the University Park hotel as an asset held for sale.

must be defined and enforced in the context of the performance of a known duty. Here, Mr. Potts served as the concurring partner and any due care he was expected to use had to be measured by the known parameters of that role. As the AICPA elaborates in its brief as *amicus*, that organization struck a careful balance in its concurring reviewer guidelines, striving to place sole responsibility for the audit in one person—the engagement partner. The Commission's resort to GAAS is thus doubly flawed, for it subverts the critical role of the engagement partner, while ignoring the due process implications for someone in Mr. Potts' position. This reliance on GAAP and GAAS standards—which are entirely silent on concurring partner review—only demonstrates how little guidance there was to advise Mr. Potts how strenuously he should have challenged the engagement partner during the Kahler audit.

In a patent effort to insulate its decision from review, the agency also claims that the standard was established by expert testimony in this proceeding—a dubious due process proposition itself (particularly in light of the AICPA standard and the interpretation of that standard by Touche), but one that collapses because the expert testimony confirms that there was no clearly established standard. On *direct* examination, Commission expert Donald Moulin explained why he was testifying on behalf of the agency:

> I felt that the profession would be enhanced if there were a clarification of the requirements so that others in the profession would really understand clearly what was intended by the SEC Practice Section rules on concurring review.

(J.A. 459.) This testimony obviously did not address the issue whether the standards for concurring partner review in

1989 and 1990, when the Kahler audit was performed, would have adequately apprised the accountant doing a concurring review what was expected.

The Commission also quotes from Edward Kerans, an expert retained by Mr. Potts. The agency's use of this testimony is misleading in its inference that Mr. Potts failed to meet the standards of care expected of him. On the contrary, Mr. Kerans testified that Mr. Potts:

> did appropriately fulfill his concurring partner responsibilities as outlined in the Touche Ross policies and as required in the guidelines ... specified in the [AICPA's] SEC Practice Section reference manual.

(J.A. 633). To the extent that experts differ, moreover, there is no basis for inferring that the standards of conduct expected of a concurring partner were "well established."

The Commission also argues that it had addressed the role of the concurring partner in prior decisions. This assertion wholly ignores the admission the agency made in its decision, that:

> this matter represents the *first* litigated proceeding to come before us involving an accountant acting *solely* as a concurring partner, ...

(A. 34.) (Emphasis added.) In his opening brief, as well as that of *amicus* AICPA, Mr. Potts also explained how this precedent said nothing about the duty he had assumed. The Commission must agree, for it fails utterly to demonstrate what guidance Mr. Potts could have gleaned from those decisions.

In short, not one of the sources on which the Commission relies here overcomes what Mr. Potts asserted earlier—that

the standard of the AICPA SEC Practice Section, the only applicable industry standard, provided no notice of the standard of conduct that proved to be the basis of the Commission's punitive sanction. Further, Mr. Potts did what he was supposed to do—comply with the applicable standard. Thus, nothing the Commission has said obviates the need for review to establish what level of clarity the agency must establish before it can punish a professional who practices before it.

II. Review is Warranted to Reconcile the Decision Below With That of the Second and District of Columbia Circuits.

The Commission's decision, affirmed by the Eighth Circuit, enunciated new and altogether different standards for concurring partners. It now appears that compliance with the AICPA SEC Practice Section standards, or even more detailed firm standards, is insufficient to avoid a sanction under Commission Rule 2(e). The Commission has transformed the concept of due care when *reviewing* an audit into something entirely different. The concurring partner must now be prepared to audit the audit and subsume critical functions of the engagement partner.

As the Commission did in *Upton v. S.E.C.*, 75 F.3d 92 (2d Cir. 1996), it has used this case to articulate a new rule for a profession. Here, it is what is expected of concurring partners; in *Upton*, it was to clarify how a brokerage firm could meet its minimum capital requirements. The Second Circuit overturned the agency's sanction in *Upton* on the ground that the new rule should be imposed only prospectively. *Id.* at 98 The Commission makes the facile argument that *Upton* is distinguishable because here Mr. Potts

"did not comply with the literal terms of a governing rule." SEC Brief in Opposition at 16. But Mr. Potts in fact complied with the AICPA Practice Section guidelines, a point the Commission has never disputed. The duty of due care, which the Commission said was violated here, could only have been defined in terms of the standards set by the AICPA SEC Practice Section (and those of Touche), which Mr. Potts met. In its retroactive application, the decision below simply cannot be reconciled with *Upton*.

Likewise, the decision in the District of Columbia Circuit reached in *Checkosky v. S.E.C.*, 23 F.3d 452 (D.C. Cir. 1994), *after remand*, 139 F.3d. 221 (D.C. Cir. 1998), conflicts with the decision below. The Commission found that the accountants in *Checkosky* had acted with scienter, 23 F.3d at 481; 139 F.3d at 223, but held as well that mere negligence was sufficient to discipline accountants, 23 F.3d. at 458, 475; 139 F.3d at 223-24. The failure to specify the level of culpability that bedeviled the agency in *Checkosky* exists here, for Mr. Potts was likewise forced to defend charges of improper professional conduct without knowing what was the minimum level of culpability sufficient to justify Rule 2(e) punishment.

Equally significant in *Checkosky* was the Commission's continued failure to justify its differential treatment of accountants from attorneys when administering Rule 2(e). *See* 23 F.3d at 485. In its decision *In re Carter*, 47 S.E.C. 471 (1981), the Commission acted prospectively, because it recognized that the standards the attorneys looked to were general and required the exercise of professional judgment. That is equally the case here. The agency tries to distinguish *Carter* on the ground the professional norms there were not adequately established. SEC Brief in Opposition at 14 n.4. But attorneys, like accountants, must exercise due care in

performing their duties. Conversely, accountants, like attorneys, must exercise professional judgment when performing an audit. Review is thus warranted to reconcile the differing results in the courts below.

III. The Decision Below Effects a Sweeping Change in Accounting Practices.

The Commission conceded in its decision that this case was the first instance in which it had addressed the conduct expected of a concurring partner when serving solely in that capacity. While it had mentioned that term in a few other decisions, the Commission implicitly conceded that those decisions offered no assistance to the accountant seeking to learn what was expected or potentially sanctionable conduct. This case is intended to make new law and set new standards for auditing practices.

As the AICPA sets forth in its brief *amicus curiae*, the changes the Commission has effected are profound for the many firms and thousands of accountants who audit publicly held companies. In its guidelines the AICPA requirement of a concurring review struck a crucial balance between quality assurance, primary audit responsibility and cost, a balance the Commission now wholly disregards. Lacking express authority to regulate auditory standards, the Commission has used this case to articulate, ad hoc, new auditing standards. The Commission's arrogation of AICPA auditing standards to a use for which they were never intended threatens the useful public-private cooperation that has existed between the Commission and the AICPA. *See* Brief of AICPA *amicus curiae* at 5. Thus, there is an overriding public interest for this Court to address the manner in which the Commission has elected to exercise that authority in this case.

CONCLUSION

For the foregoing reasons and those advanced earlier, Mr. Potts requests that the Court grant the petition for certiorari to review the decision of the Eighth Circuit in this case.

Dated: April 9, 1999

Respectfully submitted,

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